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C O N F I D E N T I A L SECTION 01 OF 02 BAKU 000218

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SUBJECT: AZERBAIJAN: BTC PARTNERS APPROVE EXPANSION, ACG
PARTNERS APPROVE CHANGED PROFIT SPLIT

Classified By: Ambassador Anne E. Derse, reasons 1.4 (b,d)

11. (C) SUMMARY: On March 6 the BTC Partners voted to approve expansion of the BTC pipeline from one to one point two million barrels per day (mmbd), despite strong opposition from the Government of Azerbaijan. Earlier, the ACG Partners had agreed to "provisionally and without prejudice" change the profit split from ACG oil from 50-50 to 80 percent for the GOAJ and 20 percent for the ACG Partners as of April 1, 12008. The GOAJ might still seek to delay BTC expansion to 1.2 mmbd until ownership questions relating to BTC after the "zero balance date" of 2024 are resolved. Provisional resolution of the profit split issue, long the major bone of contention between the ACG Partners and the GOAJ, could help expedite development of ACG Deep Gas. END COMMENT.

12. (C) On March 7 Energy Officer met with a western energy executive representing one of the BTC shareholder companies, who had been present at the previous day's BTC board meeting to discuss the previous day's events (Background: BTC Shareholders are: BP, Socar, Chevron, Statoil Hydro, TPAO, Eni/Agip, Total, Itochu, Inpex, Conoco Phillips, and Hess). The main issue before the BTC board during the meeting was whether to approve expansion of the BTC pipeline from one to one point two million barrels a day. This expansion would be achieved by introducing Drag-Reducing Agents (DRAs) into the pipeline. A vote against expansion, by cutting off funding, would have essentially stopped expansion for the time being.

Zero Balance Date

13. (C) According to the energy executive, the GOAJ was linking expansion to 1.2 mmbd to the status of the BTC pipeline after "zero-balance date" (ZBD) in 2024, i.e. when ownership of the BTC pipeline reverts back from the BTC Partners to Azerbaijan. According to the current BTC PSA, post-ZBD the BTC partners will reserve capacity rights for the pipeline, which means that they will get to ship oil basically at operational cost, without having to pay any tariff. The GOAJ position is that the BTC partners by ZBD will have recovered their investments plus 12.5 percent, and as such should have no preferential rights, and should have to pay a tariff to the GOAJ for all volumes shipped. An intermediate position between the BTC Partners and the GOAJ was that the BTC partners should reserve some preferential rights and as such pay a discounted tariff after ZBD. (COMMENT: According to a March 7 discussion between the Ambassador and SOCAR President Abdullayev, the main issue post-ZBD is that increased non-Azerbaijani volumes through BTC lowers GOAJ ownership of the pipeline. Embassy will follow up to learn more about this GOAJ concern).

¶4. The Energy Executive said that during the meeting Sofaz Executive Director Shahmar Movsumov, speaking on behalf of Socar, Sofaz and AzBTC (AzBtcv is a limited liability company formed in 2002 as a partner in the BTC, representing Azerbaijan in the BTC project), spoke out harshly against approving expansion, saying "a vote for this motion was a vote against Azerbaijan," and he urged the BTC partners to vote against it. Those BTC members speaking for the motion pointed out that their role as BTC directors was to do what was best for BTC, not for their respective companies and countries. They said that negotiation for BTC status after ZBD could continue, and did not have to be settled before deciding on BTC expansion to 1.2 mmbd. They also warned that projections show that as of August 2008 there could be a surplus of nominated volumes for the BTC pipeline over capacity, i.e. expected volumes from ACG Partners' plus Shah Deniz condensate (to say nothing of third-party shippers' volumes) could exceed capacity. If BTC directors did not vote to approve expansion, legal claims could be initiated against the BTC Partners by these companies who have already nominated volumes.

What is At Stake

¶5. (C) Just before the vote for expansion to 1.2, Movsumov said he was not going to vote and left the room. All other BTC partners (i.e. the non-Azerbaijani members) voted for the expansion. In another vote, AzBTC voted against funding USD 9 million to continue work on the eventual expansion of BTC to 1.6 mmbd, although the other BTC partners voted for this funds allocation and the motion carried.

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¶6. (C) Although the BTC expansion to 1.2 mmbd carried, according to the energy executive SOCAR Deputy Vice-President Vitaliy Baylarbayov, present at the meeting, intimated that this expansion could still face problems when seeking to get a pending permit from the Ministry of Emergency Situations (COMMENT: Other BTC members have also mentioned the possibility of MES blocking expansion).

Profit Split

¶7. (C) Separately, on March 4 EnergyOff a western energy executive from an ACG Partner company relayed that the ACG Consortium has decided that come April 1 the profit split would shift to 80-20 in favor of the GOAJ (although factoring in transportation costs it goes to 75-25 percent in favor of GOAJ). This would be done, as was the January 1, 2008 switch to 50-50, on a 'provisional, without prejudice' basis, until all ACG Partners agree on a permanent solution. (Comment: a March 4 'Interfax' story quoted President Aliyev as saying that Azerbaijan would 'soon' receive 80 percent of revenue from ACG fields. The ACG Partnership had decided in December that the profit split would go to from 20-80 percent (GOAJ-ACG Partnership) to 50-50 come January 1, 2008 on a "provisional, without prejudice" basis).

Another Bullet Dodged

¶8. (C) COMMENT: The industry contact who provided the readout of the BTC board meeting was buoyed that the non-GOAJ BTC Partners "hung together" and approved expansion, despite a strong push from Azerbaijan. It is unclear if Movsumov railed against expansion knowing it was going to pass regardless, or whether in fact he sought by his comments to peel off support, but then chose not to vote when he realized he was going to lose. Regardless, the vote in support of BTC expansion to 1.2 mmbd was a necessary (but not sufficient) condition for timely expansion to 1.2 mmbd, which itself is crucial. Timely BTC expansion to 1.2 mmbd is crucial both to

accommodate increased ACG volumes (as additional ACG wells come on line later this year), possible Tengiz volumes (slated to being in June or July), and most importantly Shah Deniz condensate volumes. There is only a two-day storage capacity for Shah Deniz condensate at Sangachal, so if it cannot be shipped through BTC, after approximately two days Shah Deniz gas production would have to be shut in, i.e. stopped. We underscore however that BTC Board approval is only the first step. There are many ways the GOAJ can slow or thwart implementation as leverage in the post-ZBD negotiations - notably by the MES withholding the needed permit.

19. (C) COMMENT (CONTINUED): The news that the ACG Partners have at least provisionally resolved the profit-split issue with SOCAR is also very good news, as it increases the possibility that the GOAJ will reach an agreement with the ACG Partners on extension of the PSA and, more importantly for the Southern Corridor project, beginning developing ACG Deep Gas. It also should be noted that due to this agreement, as of April 1 Azerbaijan will be getting more money from ACG oil than before. END COMMENT.
DERSE